Qualified Business Income
– Excerpt from Tax Cuts and Jobs Act Course by Paul Winn

Nature of the 20% Deduction for Qualified Business Income

Section 199A of the Internal Revenue Code added a deduction as a result of the passage of The Tax Cuts and Jobs Act of 2017 of up to 20% for qualified business income derived from a qualified trade or business.

Two components comprise the deduction for which taxpayers may be eligible:

1. A deduction of up to 20% of qualified business income from a domestic business, subject to limitations based on –
    - the type of trade or business,
    - the taxpayer's taxable income,
    - the amount of W-2 wages paid by the trade or business, and
    - the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business.; and
2. A deduction of up to 20% of the taxpayer's combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

The total of the qualified business income, referred to in item 1, and the REIT and PTP income in item 2 is referred to as the "combined qualified business income amount." The deduction is generally equal to the ***lesser*** of:

1. The combined qualified business income amount; and
2. The taxpayer's taxable income reduced by the taxpayer's net capital gain.

Deduction Eligibility

Pursuant to the provision of the TCJA creating the deduction, taxpayers who may be eligible for the deduction are those who operate a business as a sole proprietor or through a pass-through entity. Accordingly, individuals, trusts and estates with qualified business income, qualified REIT dividends or qualified PTP income may qualify for the deduction. Income earned as an employee or through a C Corporation is ineligible for the deduction.

Eligibility for the pass-through deduction authorized by the TCJA does not require that the taxpayer choose to itemize tax deductions. Accordingly, eligibility for any pass-through deduction is unaffected by the taxpayer's election to itemize deductions or take the standard deduction.

Pass-Through Deduction for Qualified Trade or Business

The TCJA, §11011, provides for a deduction of up to 20% of a pass-through business' qualified business income. The deduction, depending upon the amount of qualified business income and other factors affecting it, may reduce the taxpayer's income tax liability significantly. However, the "other factors" that affect the deduction include:

- Whether the business is a qualified trade or business;
- The taxpayer's taxable income if the business is a specified service trade or business;
- The amount of W-2 wages paid; and
- The value of qualified property.

The amount of the pass-through deduction is equal to:

3. The ***lesser of*** A or B, where:

    A is 20% of the combined qualified business income; and

    B is the greater of –
    - 50% of W-2 wages paid, or
    - 25% of W-2 wages paid + 2.5% of unadjusted basis of qualified property

plus

4. 20% of the total amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income for the taxable year.

Thus, critical to an understanding of the pass-through deduction are the definitions of:

- Pass-through business;
- Qualified trade or business;
- Qualified business income;
- Combined qualified business income; and
- Qualified property.

Let's consider each of these definitions.

Pass-Through Business

A pass-through business, for purposes of the pass-through deduction, is a business organized and taxed as other than a regular corporation. Accordingly, the pass-through deduction is available to an otherwise qualified taxpayer whose business is organized as:

- A sole proprietorship;
- A partnership;
- A limited liability company (LLC) taxed as a partnership; and
- An S corporation.

In each of these business entities, gains and losses are passed through to the business owner and taxed in the owner's income tax bracket rather than being taxed when received by the business entity. Thus, the income of a sole proprietorship is taxed as part of the income of the sole proprietor. Similarly, partners are taxed on their portion of the partnership income, members of a limited liability company taxed as a partnership are taxed on their part of the LLC's income, and stockholders of a corporation making an S election are taxed on their part of the corporate income. In contrast, gains and losses experienced by corporations other than those making an S election and LLCs not choosing to be taxed as partnerships are subject to taxation while in the hands of the business entity.

Qualified Trade or Business

A qualified trade or business, as the term is used with respect to the pass-through deduction, means any trade or business ***other than***:

- A specified service trade or business; or
- The trade or business of performing services as an employee. (In other words, an employee of a business would not be considered a "qualified trade or business" whose income from such employment would qualify for the pass-through deduction.)

A "specified service trade or business" is any of the following:

- Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
- Any banking, insurance, financing, leasing, investing, or similar business;
- Any farming business (including the business of raising or harvesting trees);
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A (depletion);
- Any business of operating a hotel, motel, restaurant, or similar business; and
- Any business involving the performance of services that consists of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Thus, an employee would not qualify for the pass-through deduction, with respect to wages received as an employee. Nor would the specified service trades or businesses listed be considered a qualified trade or business eligible for the pass-through deduction. However, if the taxpayer's business is a specified service business, the sole proprietor, partner, LLC member or S corporation stockholder would qualify for an exception to the disqualification and could be eligible for the pass-through deduction (if otherwise eligible) provided the taxpayer has taxable income below certain amounts.

Exception for Specified Service Trade or Business Based on Taxpayer's Income

The rule cited just above that disqualifies specified service trades or businesses from being considered qualified trades or businesses for purposes of the pass-through deduction does not apply to individuals whose taxable income is less than the threshold amount[1] ($315,000 for joint filers, $157,500 for all others in 2018) plus $100,000 in the case of a joint return and $50,000 for all others.

The specified service business of an individual whose taxable income is less than the threshold amount plus $50,000 or $100,000, as applicable, will be treated as a qualified trade or business for purposes of the pass-through deduction. However, if the individual's taxable income exceeds the threshold amount but not the amount at which he or she would be disqualified for the deduction, the qualified business income is reduced by the ratio of the taxpayer's taxable income in excess of the threshold amount to $50,000 (or $100,000 in the case of a joint return). Realizing this could be confusing, let's look at an example.

Suppose a single taxpayer is a sole proprietor of a specified service business, (a) has a taxable income of $177,500, i.e. $20,000 in excess of the threshold amount for the taxpayer's single filing status, $130,000 of which is comprised of qualified business income attributable to the specified service business, and (b) the business pays sufficient W-2 wages so that the wage limitation does not apply. The pass-through deduction is reduced if:

(a) the business is a specified service business and
(b) the taxpayer has a total taxable income within the phase-in range

(See **Qualified Business Income** below.) Since the pass-through deduction is reduced **only** if both (a) and (b) apply, the following calculations are needed to determine the deduction.

The following calculations determine:

1. The applicable reduction in the qualified business income for purposes of the pass-through deduction (because the business is a specified service business ***and*** the individual's taxable income exceeds the threshold amount):

$\frac{\text{Taxable income – Threshold amount}}{\text{Applicable range}}$	x	Qualified business income	=	Applicable reduction
$\frac{\$177,500 - \$157,500}{\$50,000}$	x	$130,000	=	$52,000

2. The includible qualified business income:

Qualified business income	-	Applicable reduction	=	Includible qualified business income
$130,000	-	$52,000	=	$78,000

3. The qualified business income deduction:

Includible qualified business income	x	20%	=	Qualified business income deduction

[1] The threshold amount is adjusted for inflation for years after 2018.

$78,000	x	20%	=	$15,600

Qualified Business Income

The term "qualified business income" for any taxable year means the net amount of qualified items of:

- Income,
- Gain,
- Deduction, and
- Loss

… with respect to any qualified trade or business of the taxpayer to the extent they—the income, gain, deduction and loss—are effectively connected with the conduct of a trade or business within the United States and included or allowed in determining taxable income for the taxable year. Thus, qualified business income is limited to items of income, gain, deduction and loss only insofar as they are "effectively connected" with the taxpayer's conduct of a trade or business within the United States.

In the case of a qualified trade or business engaged in trade or business within the United States during the year, "effectively connected income" varies, depending on the source, and means:

- With respect to gain or loss from the sale or exchange of capital assets –
    - income, gain, or loss derived from assets used in or held for use in the conduct of such trade or business, or
    - the activities of such trade or business were a material factor in the realization of the income, gain, or loss;
- With respect to other income from sources within the United States, all income, gain, or loss;
- With respect to income, gain, or loss from sources outside the United States, provided the business has an office or other fixed place of business within the United States to which the income, gain, or loss is attributable, income gain or loss –
    - consisting of rents or royalties for the use of or for the privilege of using intangible property derived in the active conduct of the trade or business,
    - consisting of dividends, interest, or amounts received for the provision of guarantees of indebtedness –
        - derived in the active conduct of a banking, financing or similar business within the United States, or
        - is received by a corporation the principal business of which is trading in stocks or securities for its own account; or
    - derived from the sale or exchange through the office or other fixed place of business of personal property other than property sold or exchanged for use, consumption, or disposition outside the United States if an office or other fixed place of business of the taxpayer in a foreign country participated materially in the sale; and
- With respect to income from sources outside the United States derived by a qualified trade or business taxable under part I or part II of subchapter L (insurance companies) and which is attributable to its United States business.

Exceptions to Qualified Business Income

Certain investment items are ***not taken into account*** nor considered as qualified items of income, gain, deduction or loss, including:

1. Any item of short-term capital gain, short-term capital loss, long-term capital gain or long-term capital loss;
2. A dividend, income equivalent to a dividend, or payment in lieu of dividends;
3. Any interest income other than interest income that is properly allocable to a trade or business;
4. Any item of gain or loss generally derived from commodities or foreign currency transactions;
5. Any item of income, gain, deduction or loss derived from notional principal contracts;
6. Any amount received from an annuity which is not received in connection with the trade or business; and
7. Any item of deduction or loss properly allocable to an amount described in 1 through 6 above.

As a result, these investment items do not play a part in the calculation of qualified business income for purposes of the pass-through deduction.

Combined Qualified Business Income

A taxpayer's *combined* qualified business income for any taxable year is equal to the sum of A and B where:

> A is equal to the qualified business income (discussed above) for each qualified trade or business carried on by the taxpayer; and
>
> B is equal to 20% of the total amount of qualified REIT dividends and qualified publicly traded partnership (PTP) income for the taxable year.

Qualified REIT Dividend

The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which is neither a capital gain dividend nor qualified dividend income.

Qualified Publicly Traded Partnership Income

The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of A and B where:

> A is the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss from a publicly traded partnership which is not treated as a corporation; and
>
> B is any gain recognized by the taxpayer upon disposition of its interest in the partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset.

Qualified Property

Qualified property plays a part in the calculation of the pass-through deduction because an alternative to deduction of 20% of qualified business income is a deduction of the lesser of A or B where A is 50% of W-2 wages and B is the greater of 25% of W-2 wages ***plus*** 2.5% of the unadjusted basis of qualified property.

The term "qualified property," as used with respect to the pass-through deduction, means tangible property:

- Subject to depreciation under IRC §167;
- Held by and available for use in a qualified trade or business at the close of the taxable year;
- Held at any point during the taxable year in the production of qualified business income; and
- The depreciable period (see **Depreciable Period** below) for which has not ended before the close of the taxable year.

Depreciable Period

The term "depreciable period" means, with respect to a taxpayer's qualified property, the period of time beginning on the date the property was first placed in service by the taxpayer and ending on the later of:

- 10 years after the date first placed in service; or
- The last day of the last full year in the recovery period applicable to the property under IRC §168 (without regard to subsection (g) relating to the alternative depreciation system for certain property))

W-2 Wage Limitation

The amount of wages paid by the qualified trade or business needs to be determined because wages paid to employees may act as a limit on the amount of the pass-through deduction. If a qualified trade or business pays no W-2 wages (assuming it also has no qualified property), the taxpayer will have no pass-through deduction.

As recited in IRC §3401(a), W-2 wages for purposes of the wage limitation applicable to the pass-through provision means "…all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Accordingly as recited in IRC §6051, it includes "…the total amount of elective deferrals … and compensation deferred under section 457, including the amount of designated Roth contributions…."

Certain types of remuneration, however, are specifically excluded; among the excluded types of remuneration is remuneration paid for domestic service in a private home.

Determining W-2 Wages

IRS Notice 2018-64 provides three definitions of wages that may be used in determining W-2 wages for purposes of the pass-through provision and which are referred to as:

1. The unmodified box method;
2. The modified box 1 method; and
3. The tracking wages method.

Unmodified Box Method

Using the unmodified box method, W–2 wages for purposes of the pass-through would be calculated simply by taking the lesser of A or B where:

A is the total of the entries in box 1 (Wages, tips, other compensation) of all the W–2 Forms filed by the taxpayer with the Social Security Administration, and

B is the total of the entries in box 5 (Medicare wages and tips) of all the W–2 Forms filed by the taxpayer with the Social Security Administration.

Modified Box 1 Method

Alternatively, a taxpayer may elect to use the modified box 1 method. Using the modified box 1 method, W–2 wages for purposes of the pass-through provision would be calculated as follows:

1. Total the amounts in box 1 (Wages, tips, other compensation) of all the W–2 Forms filed by the taxpayer with the Social Security Administration;
2. From the total amount determined in step one, subtract any amounts included in box 1 not considered wages for federal income tax withholding purposes, including amounts that are not wages but are treated as such for purposes of income tax withholding under IRC §3402(o), including –
   a. supplemental unemployment compensation benefit paid to an individual,
   b. annuity payments to an individual, if at the time the payment is made a request that such annuity be subject to withholding under this chapter is in effect, and
   c. payment to an individual of sick pay which does not constitute wages, if at the time the payment is made a request that it be subject to withholding under this chapter is in effect;
3. Finally, add to the amount calculated (by subtracting the result in step two from the result in step one) the total of any elective deferral amounts that are reported on the W–2 Forms in box 12 coded D, E, F, G and S.

Tracking Wages Method

The third method for calculating W–2 wages, i.e. the tracking wages method, requires the taxpayer to track total wages subject to federal income tax withholding and makes certain adjustments. Using the tracking wages method, W-2 wages for purposes of the pass-through provision would be calculated in the following manner:

1. Determine the total amount of wages subject to federal income tax withholding that were paid to employees of the taxpayer for employment by the taxpayer and which are reported on the W-2 forms filed with the Social Security Administration;
2. to the amount determined in 1 (above), add the total of the elective amounts reported in box 12 coded D, E, F, G and S.

Calculating the Deduction

Calculating the pass-through deduction requires the answers to the various elements be determined and then substituted in the formula. The important elements are:

- Qualified business income;
- Combined qualified business income;
- W-2 wages;
- Unadjusted basis of qualified property; and
- Taxpayer's taxable income if the trade or business is a specified trade or business.

The amount of the pass-through deduction is equal to:

1. The ***lesser of*** A or B, where -

   A is 20% of qualified business income; and

   B is the greater of –
   - 50% of W-2 wages paid, or
   - 25% of W-2 wages paid + 2.5% of unadjusted basis of qualified property

   plus

2. 20% of the total amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership (PTP) income for the taxable year.

To illustrate how various combinations of these elements interact to produce the appropriate pass-through deduction, consider the following three examples:

Example 1: 50% of W-2 wages is an amount lower than 20% of qualified business income, but the business has a high unadjusted basis of qualified property (see inset for assumptions).

Qualified business income - $1,250,000
W-2 wages - $400,000
Unadjusted basis of qualified property - $6 million
No REIT dividends or PTP income

Determining the lesser of A and B is done as follows:

Step 1:

Determine A by calculating 20% of qualified business income:

$1,250,000 x .2 = $250,000

Step 2:

Determine B by calculating the greater of 1 or 2 below –

1. 50% of W-2 wages paid:

   $400,000 x .50 = $200,000

   or

2. 25% of W-2 wages paid *plus* 2.5% of unadjusted basis of qualified property

   a) $400,000 x .25 = $100,000

   plus

   b) $6,000,000 x .025 = $150,000

   $100,000 + $150,000 = $250,000

Since A equals $250,000 and B, being the greater of $200,000 or $250,000, also equals $250,000 the results of A and B are both $250,000. Because there are no REIT dividends or PTP income the deduction is, therefore, $250,000.

Example 2: Business is a ***specified trade or business***, and the ***taxpayer's taxable income exceeds the threshold*** (see inset for assumptions).

Qualified business income - $1,250,000
W-2 wages - $200,000
Unadjusted basis of qualified property - $6 million
Taxpayer's taxable income - $350,000
Taxpayer's filing status - MFJ

1. Applicable reduction in the qualified business income is determined as follows:

Taxable income – Threshold amount / Applicable range	X	Qualified business income	=	Applicable reduction
$350,000 - $315,00000 / $100,000	X	$1,250,000	=	$437,500

2. Includible qualified business income is determined by subtracting the reduction (determined in 1. above) from the client's qualified business income as follows:

Qualified business income	-	Applicable reduction	=	Includible qualified business income
$1,250,000	-	$437,500	=	$812,500

3. 20% of qualified business income:

Includible qualified business income	x	20%	=	Tentative business income deduction
$812,500	x	20%	=	$162,500

Determining the lesser of A and B is done as follows:

Step 1:

Determine A by calculating 20% of qualified business income:

$812,000 x .2 = $162,500

Step 2:

Determine B by calculating the greater of 1 or 2 below –

1. 50% of W-2 wages paid:

   $200,000 x .50 = $100,000

   or

2. 25% of W-2 wages paid *plus* 2.5% of unadjusted basis of qualified property

   a) $200,000 x .25 = $50,000

   plus

   b) $6,000,000 x .025 = $150,000

   $50,000 + $150,000 = $200,000

Since A equals $162,500 and B, being the greater of $100,000 or $200,000, is $200,000 the deduction is, therefore, the smaller of $162,500 or $200,000, i.e. $162,500.

Example 3: 50% of W-2 wages is less than 20% of qualified business income, and business has low unadjusted basis of qualified property (see inset for assumptions).

Qualified business income - $1,250,000
W-2 wages - $400,000
Unadjusted basis of qualified property - $2 million
Total REIT dividends and PTP income - $50,000

Determining the lesser of A and B is done as follows:

Step 1:

Determine A by calculating 20% of qualified business income:

$1,250,000 x .2 = $250,000

Step 2:

Determine B by calculating the greater of 1 or 2 below –

1. 50% of W-2 wages paid:

   $400,000 x .50 = $200,000

   or

2. 25% of W-2 wages paid *plus* 2.5% of unadjusted basis of qualified property

   a) $400,000 x .25 = $100,000

   plus

   b) $2,000,000 x .025 = $50,000

   $100,000 + $50,000 = $150,000

Step 3:

Add 20% of the total qualified REIT dividends and qualified PTP income –

$50,000 x .2 = $10,000

Since A equals $250,000 B is $200,000, and 20% of the total qualified REIT dividends and qualified PTP income is $10,000, the deduction is, therefore, the smaller of $250,000 or $210,000, i.e. $210,000.